City National Rochdale®
INVESTMENT MANAGEMENT

Economic Perspectives

ECONOMIC GROWTH REMAINS RESILIENT

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After 12 months of muted progress, there are indications that the U.S. economy is once again poised to rebound over the next couple of quarters. The slow, uneven pace of growth this cycle has been frustrating. It has been fast enough to reduce the output gap (albeit only gradually), but a breakout in activity in one or two sectors seems to only be accompanied by pullbacks in others. Still, after seven years of expansion, and through all the stops and starts, the U.S. economy remains a resilient engine of growth. While the economy is not running on all cylinders, the most important ones are firing away, and those that are sputtering may just have some spark in them yet.

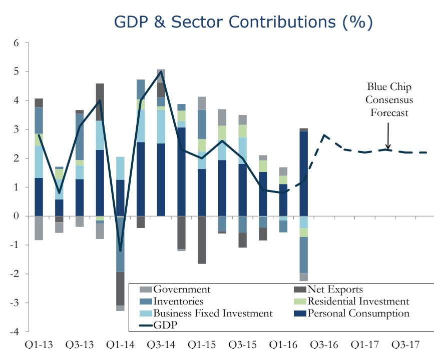
Looking under the hood, the consumer sector has clearly been the driving force behind growth, as households have begun dipping into a year's worth of accumulated savings from low gas prices and rising incomes. Although the recent spending surge is unlikely to be sustained, there is little reason to believe consumers will be retrenching anytime soon. The rally in the stock market, along with steady growth in home prices, is pushing household wealth to record levels and helping keep confidence elevated. Most importantly, the labor market remains healthy, and the recent acceleration in wages should give households new support as the boost from lower energy prices fades.

Another source of strength for the economy has been the ongoing recovery in housing. Over the last several years, home building has experienced significant growth, albeit off of low levels, and this expansion has added to overall GDP growth. In fact, since the last quarter of 2011, gains in home building have been responsible for 20.0% of the total economic expansion. As a result, housing's overall share of the economy is climbing (slowly) back to historic norms. Home buying generates a wave of additional spending, hiring, and investment not accounted for in the purchase price of the home alone (which serves to promote even further activity in the wider economy).

Finally, government is no longer slamming on the brakes. For a long stretch, cutbacks at all levels of government were a substantial drag on economic growth. Between 2010 and 2014, the contribution from the public sector to GDP growth averaged a negative 0.42%. That is over a full percentage lower than the prior 50 year average. Government spending is now slowly back on the rise (providing a small but significant support for growth) and may be poised to step up further over the next year.

Offsetting these strengths has been weakness in inventories, exports, and business investment (*Figure 1*). Inventories in particular have been a major drag, declining for five consecutive quarters for the first time since 1957. However, there is a clear positive to this. Companies cannot continue drawing down inventories forever, and it seems likely that the inventory cycle will turn soon. The slowdown in inventory accumulation, which has tracked the weakening of industrial production, should get a boost now that

Figure 1



Source: Bureau of Economic Analysis
June 30, 2016

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headwinds (created by the dollar's surge and collapse in energy prices) are finally subsiding and activity is showing signs of a turnaround.

While it is unlikely that industrial production will soon swing back to the position of strength it held earlier in the expansion, a bottoming in the sector's slump would reduce a significant drag on overall economic growth going forward. There is reason to be cautiously optimistic about the outlook for exports now that the dollar has been broadly stable for the past six months. Likewise, after contracting for the past three quarters, there have been encouraging signs that business investment will rebound soon, if only because the massive drag from mining has faded.

In a perfect world, all cylinders of the economic engine would be firing in unison. However, this rarely happens, and when it does, it is not for very long. Nevertheless, as long as the economy can get enough power from enough of the cylinders, there is little reason to worry about stalling out, though the cruising speed may disappoint.

THE FED

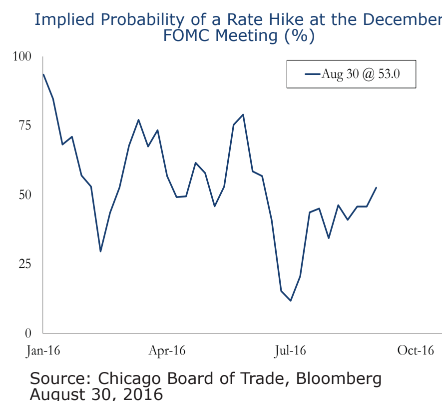
There has been a shift at the central bank; the Fed is getting ready to raise interest rates.

There has been a shift at the central bank; the Fed is getting ready to raise interest rates. When it does, it will mark the first rate increase of the year. The last time the Fed increased rates was back in December, which was its first rate increase in about 10 years. The economy is strong enough to handle it; the unemployment rate shows near full employment, and inflation is trending up, albeit slowly, toward its target of 2.0%. Furthermore, international events have calmed down. The most recent event, the Brexit vote in the United Kingdom, had only an initial shock to the market. It was not the "Lehman Event," when the credit markets froze, that many had feared.

Despite these points, the Fed will not commit to making the move until there is a stronger consensus among policy makers. While there are some members who are ready for the rate increase, about two-thirds of the committee are still on the fence or are not ready for the rate increase to happen at this time (they want to see more economic data before making a decision). Still, the market is pricing in a higher probability of a Fed rate hike in December (*Figure 2*).

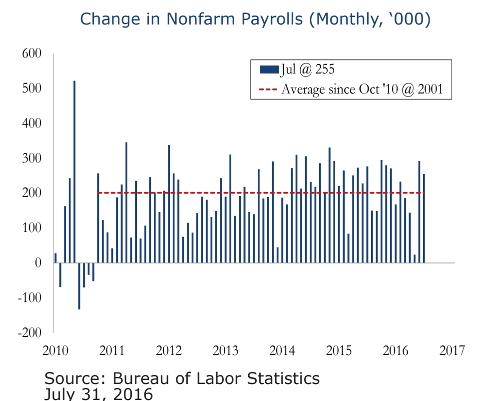
LABOR

Figure 2



Source: Chicago Board of Trade, Bloomberg
August 30, 2016

Figure 3



Source: Bureau of Labor Statistics
July 31, 2016

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Job growth has had two consecutive months of vigorous labor growth, reversing the slump that occurred this past spring (*Figure 3*). The unemployment rate remained unchanged at 4.9%, which marks the third consecutive month that it has stayed below 5.0%. The labor force participation rate resumed an upward trend, reaching 62.8%, an encouraging sign (it has increased in seven of the past 10 months).

Job growth has had two consecutive months of vigorous labor growth.

One reason for the increase in the participation rate may be higher wages. The continuation of better wage growth has been a welcome reprieve. Average hourly earnings have increased 2.7% in the past year. This marks the second consecutive month that they have been above 2.5%. Prior to that, the earnings increase was in a range of 2.0% to 2.5% for five consecutive months. That said, the pace of wage gains remains modest compared to the past several recoveries.

It is believed that the two strong reports have reignited optimism that the Fed will be able to get back on track to raise interest rates.

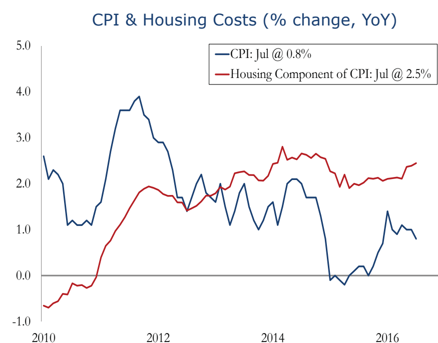
INFLATION

Price pressures remained tame last month, due in part to the recent drop in energy prices, which fell 1.6% in July (the first pullback in four months). Oil prices were the major driving force, as they retreated $6.73, to $41.60 (-13.9%). This places the Consumer Price Index (CPI) at 0.8% for the past year. Overall, inflation has been under pressure ever since oil prices began falling from $100 per barrel in the summer of 2014.

Housing costs are putting upward pressure on CPI.

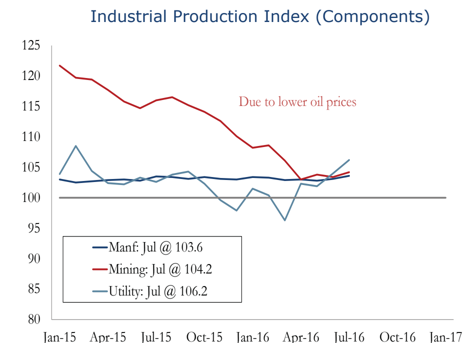
Meanwhile, the Core Personal Consumption Expenditures Price Index (Core PCE), which excludes the volatile food and energy prices, is up 2.2% in the past year. Housing costs are putting upward pressure on this inflation measurement. Housing prices increased 0.3% last month and are up 2.5% in the past year. Housing has been the driving force behind overall inflation, as it has an overbearing impact on CPI, making up 42% of the index. Since early 2013, the annual change in housing costs has been above the overall CPI rate (*Figure 4*). There are several subcomponents of housing: the cost of owning a home (called owner equivalent rent) has increased 3.3% in the past year; the cost of renting a primary home is up 3.8%; and smaller subcomponents (such as utilities and furnishings) have had very little change in price.

Figure 4



Source: Bureau of Economic Analysis
July 31, 2016

Figure 5



Source: U.S. Federal Reserve
July 31, 2016

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INDUSTRIAL PRODUCTION

Industrial production is made up of three components: manufacturing (78.0%), mining (11.0%), and utilities (11.0%).

Production hit a cycle peak back in late 2014 but has suffered since then due to several factors: a commodity disinflation cycle that began around that time (which included a rapid drop in oil prices), a strengthening dollar (which led to a lack of competitively priced exports), and the significant softening in global growth (which has brought down demand). However, there has been a turnaround of late, driven by a recent jump in motor vehicles and parts. Another jump came from the utility sector.

Industrial production, which is made up of three components, manufacturing (78.0%), mining (11.0%), and utilities (11.0%), is the segment to watch. Since manufacturing makes up the lion's share of industrial production, trend movement here is closely watched because of its heavy influence on the overall report. Auto production has been up these past couple of months, slightly lifting manufacturing. Oil prices, although volatile, are off their February lows, helping to stabilize the mining index. The very hot weather of the past few months has helped to lift demand for utilities (*Figure 5*).

Index Definitions

The Consumer Price Index (CPI) is a measure that examines the weighted average of prices of a basket of consumer goods and services, including transportation, food, and medical care. The CPI is calculated by taking price changes for each item in the predetermined basket of goods and averaging them; the goods are weighted according to their importance. Changes in CPI are used to assess price changes associated with the cost of living.

The Core Personal Consumption Expenditures Price Index (Core PCE) measures the prices paid by consumers for goods and services without the volatility caused by movements in food and energy prices to reveal underlying inflation trends.

The Industrial Production Index (IPI) is an economic indicator published by the Federal Reserve Board of the United States that measures the real production output of manufacturing, mining, and utilities.

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